

IRS Fact Sheet

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Withholding Required on Certain U.S. Real Property Transactions Involving Foreign Persons, IRS Warns

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The IRS today reminds all real estate and tax professionals of the withholding tax and the filing obligations with respect to two transactions in which a foreign person disposes of a U.S. real property interest. The transactions involve the disposition by a foreign person of an option or contract to acquire a U.S. real property interest, and the disposition by a foreign corporation of a U.S. real property interest by way of a transfer to a shareholder.

Disposition of an Option or Contract to Acquire a United States Real Property Interest

Under U.S. tax law, a foreign person that sells or exchanges a U.S. real property interest must report the gain on a U.S. tax return, and the buyer of the U.S. real property interest must withhold and pay to the IRS 10 percent of the gross amount paid to the foreign person. A U.S. real property interest includes options or contracts to acquire land or land improvements and leaseholds of land or land improvements. The disposition of such an option or contract by a foreign seller is reportable on the foreign seller's U.S. tax return and is subject to a 10 percent withholding tax payable by the buyer to the IRS. Under U.S. tax law, the buyer must determine if the seller is a foreign person. If the seller is a foreign person and the buyer fails to withhold, the buyer can be held liable for the withholding tax.

The IRS has become aware of instances in which foreign persons have acquired options or entered into contracts to purchase U.S. real property interests and sold the options or assigned the contracts before such instruments are exercised or executed and title to the underlying property is taken. Buyers of the options or contracts are failing to withhold and remit to the IRS the required 10 percent from the proceeds of the sale.

Transfer to a Shareholder

The IRS is also aware of potentially abusive transactions where a foreign corporation arranges a sale of its U.S. real property interest to a buyer and then transfers its U.S. real property interest to its foreign individual shareholder. The corporation often uses a quitclaim deed for the transfer, which conveys to the shareholder only the corporation's interest in the property and does not warrant good title, but other deed transfers may present similar issues. The foreign shareholder then sells the U.S. real property interest to the buyer. The foreign shareholder takes the position that, because he or she, rather than the corporation, is selling the property, some or all of the gain inherent in the foreign corporation's U.S. real property interest is subject to a maximum capital gains rate of 15 percent. That is, the foreign shareholder claims that the transfer of the U.S. real property

interest by the foreign corporation to the shareholder does not result in a corporate level tax. If the foreign corporation had directly sold the U.S. real property interest, it could be subject to tax at a rate as high as 35 percent.

The shareholder's position is incorrect. Generally, the foreign corporation (and not the foreign individual shareholder) is taxed on all of the gain inherent in the U.S. real property interest. The transaction is treated as a taxable sale of the U.S. real property interest by the corporation, either because the corporation is making a distribution to the foreign shareholder of the U.S. real property interest (which would constitute a deemed sale of such interest at the corporate level) or because the corporation is viewed as selling the entire U.S. real property interest directly to the buyer. In cases where the foreign corporation is treated as making a distribution of the U.S. real property interest, the foreign corporation is also subject to a withholding tax of 35 percent on the gain in the property, unless it qualifies for reduced withholding (see Publication 515).

Taxpayers may find the following publication, forms, IRS guidance and regulations helpful:

- Publication 515
- Form 8288
- Form 8288-A
- Form 8288-B
- Form W-7
- Form SS-4
- Form 1099-S
- Form 1120F
- Rev. Proc. 2000-35
- IRC § 1445(a) and (e)
- Treasury Regulation § 1.1445-1(b)(3)